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Acquiring Midstream Assets And Gas Agreements: Part 1

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In the acquisition of natural gas gathering systems, processing plants and related midstream assets, a primary focus of the legal due diligence process will be the gas gathering and processing (GGP) agreements associated with these assets.

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These agreements typically have long terms, and much of the value of the target midstream assets is based on the fees to be paid under these agreements for various midstream services.

The services performed under a gas gathering agreement typically include treating the raw gas from the wellhead to remove hydrogen sulfide and carbon dioxide, dehydrating the gas to remove excess water, moving the gas from the wellhead to a processing plant, and compressing the gas. The services under a gas processing agreement typically include separating the dry gas from the natural gas liquid (NGL) mix contained in a wet gas stream, among others.

The gas gathering and processing services are oftentimes provided under separate contracts between the producer and midstream company, but may all be contained in one contract.[1]

For convenience’s sake, as used herein, “GGP agreement" refers to a contract between the producer and midstream company covering the above-mentioned gas gathering and processing services, and “midstream assets” refers to the natural gas gathering systems, processing plants and related midstream assets used by the midstream company to perform its services under the GGP agreement (and which assets are the subject of the proposed sale).

Because so much of the value of the midstream assets depends on the fees to be paid under the associated GGP agreements, it is very important that the terms and conditions of these agreements be carefully reviewed prior to a buyer’s entry into a purchase and sale agreement to buy such assets (or the equity of the entities owning such assets) and become bound by such agreements.[2]

Summarized below are several key provisions in GGP agreements, along with various issues associated with these provisions, which the potential buyer of the midstream assets should carefully review and consider in its legal due diligence review of the GGP agreements.

Term and Termination

Due to the significant capital investment involved in constructing the midstream infrastructure which will service the producer's raw gas — and the need for the midstream company to have the ability to recoup that capital investment over time via service fees under the GGP agreements — such agreements typically have a long primary term.

In GGP agreements, as with customer contracts in various industries, the term will typically be extended on a year-by-year basis unless either party provides written notice to the other party (within a specified number of days prior to the end of the primary term or then-current year (if the primary term has ended)) that it is terminating the agreement. The buyer of the midstream assets will want to understand whether the GGP agreement is in the primary term (and if so, how far it is into the primary term) or renewal period.

The buyer will also want to understand how difficult it would be for either party to terminate the GGP agreement, as well as the consequences of the termination. Typical termination rights include for material breach of the GGP agreement by a party (following expiration of a cure period), and the obligations of a party claiming force majeure having been suspended for more than a specified number of days.

GGP agreements sometimes also allow the midstream company to terminate the agreement if it has become sufficiently uneconomical for the midstream company to perform under the agreement for a given period of time.

Service Levels

GGP agreements will describe the level of service that the producer is entitled to under the agreement. At its most basic level, gathering and processing services are typically provided under a firm service or interruptible service basis, each of which is described below.

Firm Service

As the name suggests, firm service provides a producer with guaranteed capacity on the applicable midstream assets up to the amount reserved by the producer. Generally, producers entitled to firm service make a required periodic payment for this reserved capacity (e.g., a minimum volume delivery commitment).

Under the firm service arrangement, the midstream company may not interrupt the service except under certain specified circumstances (e.g., certain maintenances of the midstream assets, or force majeure).

Attention should be given to these circumstances under which the midstream company may interrupt service under a firm service arrangement (e.g., what qualifies as a force majeure event, and how long it may persist), as well as the potential consequences to the midstream company of an interruption of firm service (e.g., under certain circumstances, the producer's wells which had produced the gas that the midstream company failed to timely receive may be released from the acreage dedication under the GGP agreement).

Interruptible Service

Unlike firm service, interruptible service does not entitle the producer with guaranteed capacity on the midstream assets. Accordingly, the midstream company may interrupt or reduce the service at any time for any reason (e.g., capacity constraints).

The fees paid by a producer under an interruptible service arrangement (the volumes actually delivered times the applicable rate) are typically lower than under a firm service arrangement. Midstream companies oftentimes provide different service levels to a given producer under a given GGP agreement (e.g., firm service up to a minimum committed volume, and interruptible service in excess of that volume).

The potential buyer of midstream assets will want to review all of the midstream company's GGP agreements with all producer counterparties with respect to the midstream assets to be sold to understand the firm service level volumes committed to all producers, and compare this with the midstream assets' throughput capacity, to confirm that the system has sufficient capacity to perform on the firm service commitments under all such agreements.

The same analysis should be done when it is contemplated that, following the closing of the acquisition of the midstream assets, new GGP agreements for firm service will be entered into with third parties (since the existing GGP agreements providing for firm service typically contain covenants that the midstream company will not enter into new GGP agreements with third parties which provide for equal (firm) service, unless the midstream company reasonably expects that such new commitment would not cause the system to become oversubscribed in relation to the planned capacity of the system and expected volumes for the system).

Fees

The fee structure under GGP agreements is typically fee-based, percent-of-proceeds, cost-of-service or keep-whole (and is oftentimes a hybrid of them). Each of these fee structures, and some of the benefits and risks associated with them, is set forth below.

Fee-Based

Under a fee-based arrangement, the midstream company will receive a fixed fee for its services (e.g., $0.18 per million BTU of gas gathered). Clearly, this type of fee arrangement can help protect the midstream company from declining commodity prices; with the rate fixed, the major variable impacting the midstream company's revenues would be the volume of gas gathered and processed.

Conversely, a fixed fee arrangement will limit the potential of the midstream company to benefit from increases in the price of the relevant commodities. From the perspective of the midstream company, fixed fee arrangements which extend over long time periods (which is typically the case under GGP agreements) should take inflation into account (e.g., through an annual adjustment of a base fee according to a rise in a specified inflation index).

Percent-of-Proceeds / Percent-of-Liquids

Under a percent-of-proceeds arrangement, the midstream company will process the producer's gas and, as payment for such services, keep an agreed percentage of the proceeds from the sale of the NGLs

and/or residue gas (or, alternatively, a percentage of an index-based price, minus certain adjustments). Under a percent-of-liquids arrangement, the payment received by the midstream company is a percentage of the extracted NGLs.

The midstream company will then market these NGLs and keep the proceeds of the sale of them. Under either of these arrangements, the midstream company's revenues will be directly impacted by changes in commodity prices. For this reason, some percent-of-proceeds or percent-of-liquids arrangements will include a fee floor to help limit the commodity price risk to the midstream company.

Cost of Service

Under a cost of service arrangement, the midstream company will receive a cost-of-service fee (e.g., providing for recovery of specified variable and fixed costs and expenses plus a return on invested capital) in exchange for certain services.

Keep-Whole

Under a keep-whole arrangement, the midstream company will retain the NGLs extracted from processing and return to the producer the processed natural gas with BTU value equivalent to the original unprocessed gas delivered by the producer. This arrangement is beneficial for the midstream company when NGL prices are high and rising.

Some agreements use a combination or hybrid of the above structures in their keep-whole provisions. For example, an arrangement might provide to the producer the greater value of either the entire processed stream, or the unprocessed BTU value of the gas delivered by the producer.

Terms and Conditions

Aside from understanding the basic fee structure of the GGP agreement outlined above, GGP agreements will include several terms and conditions which will impact the amount of revenues collected and/or the profits earned under the GGP agreement.

Minimum Delivery Commitment

GGP agreements providing firm service to the producer typically include a commitment from the producer to deliver a specified minimum volume of gas to the midstream company over a given period of time, or else make a payment to the midstream company based on the difference between the minimum volume commitment and the amount of gas actually delivered to the midstream company.

A pro-producer provision which is sometimes included allows the producer to apply volumes delivered in excess of the minimum delivery commitment in a given year to a different year in which the actual volumes delivered are below committed volumes.

Fuel and Gas Lost or Unaccounted For

The GGP agreement will typically include, with respect to the producer's volumes delivered into the midstream company's system, caps on gas consumed as fuel and gas lost or unaccounted for.

In the event that the midstream company were to exceed the permitted cap (typically expressed as a

percentage of volumes delivered to the system by producer) in a given period, the midstream company would need to incur additional costs to replace the gas used as fuel or lost and unaccounted for in excess of the cap.

Conditioning Fee for Nonconforming Gas

GGP agreements generally require that gas entering the midstream company's system conform to certain quality specifications.

In the event that the gas does not so conform, the GGP agreement will oftentimes give the midstream company a right to charge the producer a conditioning fee to get the gas in conformity with the quality specifications (as well as a right to refuse receipt of the gas).

Recoupment of Environmental Compliance Costs

Because it can be difficult to foresee with much clarity the amount of environmental compliance costs that may be necessitated by future environmental laws (e.g., costs relating to modifications to facilities, reducing or monitoring emissions into the environment, payment of additional fees) and to model the effects of these additional costs in any detail, GGP agreements will oftentimes include a provision enabling the midstream company to adjust the fees to be paid by producer to offset these additional environmental compliance costs associated with the midstream assets.

A more balanced version of this type of provision would require the parties to negotiate in good faith higher fees to be paid by the producer, taking into consideration the change in environmental laws which impose upon the midstream company these additional environmental compliance costs.

In the second part of this article, we will consider how GGP agreements typically address acreage dedication and well connection obligations, covenants running with the land, and assignment and change of control.

—By Greg Krafka and Jim Strawn, Winstead PC

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[1] As well, processing and fractionation of natural gas liquids are oftentimes provided under the same agreement; however, due to space constraints, this article will not discuss fractionation services in any depth.

[2] Under some circumstances (e.g., when the producer under the GGP agreements is related to the entity selling the midstream assets), the buyer of the midstream assets may be able to enter into new GGP agreements with the producer, to take effect upon the closing of the transaction, and which will replace the existing GGP agreements.

Acquiring Midstream Assets And Gas Agreements: Part 2

Law360, New York (March 23, 2017, 1:18 PM EDT) --
In the acquisition of natural gas gathering systems, processing plants and related midstream assets, a primary focus of the legal due diligence process will be the gas gathering and processing (GGP) agreements associated with these midstream assets.

Because so much of the value of the midstream assets depends on the fees to be paid under the associated GGP agreements, it is very important that the terms and conditions of these agreements be carefully reviewed prior to a buyer's entry into a purchase and sale agreement to buy such assets (or the equity of the entities owning such assets) and become bound by such agreements.

In the first part of this article, we examined aspects of GGP agreements including terms and termination, service levels and different fee structures. In this installment, we will consider how GGP agreements typically address acreage dedication and well connection obligations, covenants running with the land, and assignment and change of control.

Acreage Dedication / Well Connection Obligations

In the GGP agreement, the producer will (subject to limited exclusions) oftentimes exclusively dedicate and commit to the performance of the GGP agreement all interests of the producer and its affiliates in oil and gas leases (whether presently owned or acquired in future) covering lands located within a defined geographic area (oftentimes one or more counties) and all gas produced therefrom or attributable thereto, and all interests of the producer in all oil or gas wells (whether then existing or drilled in the future) on lands covered by any such oil and gas lease or on other lands within such defined geographic area.

Attention should be given to any carve-outs from the acreage dedication of gas and/or liquids which are dedicated to a different midstream company pursuant to separate contractual arrangements, or which are lessor's free gas, lease fuel and compressor fuel gas, gas lift gas or on-lease separated condensate.

Review of the acreage dedication provision should confirm whether the following provisions, which are fairly typical and which benefit the midstream company, are included:

- The producer shall use commercially reasonable efforts to terminate existing (or future, in the event that the producer acquires interests in additional oil and gas leases in the dedicated area subsequent to the effective date of the GGP agreement) GGP agreements with third parties in the dedicated area. This requirement to terminate may be subject to the midstream company having to match the fees under such midstream services agreement with third party to the extent that such fees are more favorable to the producer.
- The producer shall cause existing or future affiliates of producer with interests in the dedicated oil and gas leases, wells and produced gas to be bound by the GGP agreement and execute and join as a party to the GGP agreement.
- The acreage dedication contains language indicating that the dedication is a covenant running with the land (see below).

In addition, the buyer's review of the GGP agreement should include identifying the midstream company's obligations to make well connections and incur other capital expenditures on behalf of the

producer for producer's wells (and available caps on those obligations), as well as the potential consequences of not meeting those obligations (e.g., release of the well pad from the acreage dedication if the well connection is not made timely or at all).

On a related point, the buyer will also want to understand who (e.g., the midstream company or the producer) is responsible for obtaining various rights-of-way which are needed to make the well connections and who pays for obtaining the rights-of way (and if there is a cap or some other mechanism to limit the midstream company's exposure, in the event payment for the rights-of-way is the midstream company's responsibility under the GGP agreement).

Covenant Running With the Land

Because the midstream company incurs substantial costs in constructing various infrastructure to gather and process producer's gas and it is through the GGP agreements that the midstream company recoups its investment, the midstream company will want to ensure that the GGP agreement is not rejected in a potential future bankruptcy proceeding of the producer.

Towards this end, the midstream company typically requires that the GGP agreement include a provision providing that the acreage dedication is a real covenant that runs with the land. If the acreage dedication is deemed to be a real covenant that runs with the land (a real property interest), then a producer should not be able to reject the GGP agreements as executory contracts in a bankruptcy proceeding of the producer.

In the Sabine Oil & Gas Corp. bankruptcy proceedings this past year, bankruptcy judge Shelley Chapman issued a final ruling on May 3, 2016 (largely following the non-binding analysis she set forth in a March 8, 2016 ruling[1]) that allowed Sabine Oil & Gas Corp., an oil and gas exploration and production company which was the debtor in the proceeding, to reject as executory contracts certain gas gathering and related agreements with two midstream companies.[2]

Judge Chapman ruled that these agreements could be rejected as executory contracts because the agreements did not constitute or contain covenants running with the land under applicable state (Texas) law. Clearly, midstream companies do not want to find themselves in this position, and it would behoove the potential acquirer of midstream assets to review the language of the acreage dedication / covenant running with the land provisions contained in the GGP agreement relating to such midstream assets.

When reviewing the language in a GGP agreement which purports to create a covenant running with the land, the following matters, among others, should be borne in mind:

- The requirements as to what constitutes a covenant running with the land vary state by state (e.g., some jurisdictions have a horizontal privity requirement), so the language in the agreement purporting to create a covenant running with the land (and the circumstances under which the covenant was purportedly created) should be carefully reviewed in light of the applicable state law on this point.
- As a more specific iteration of the above point, one should review the interest that is conveyed to purportedly meet the "touch and concern" element of the test for covenants running with the land, to make sure it is a real property interest. Specifically, the dedication should cover the producer's interests in the applicable oil and gas lease (real property interest), and not just the produced gas (a personal property interest).

- It should be confirmed that a memorandum of the GGP agreement was filed in the real property records of the applicable county(ies), to meet the notice requirement that is generally required for a covenant to run with the land.

Assignment / Change of Control

As is customary in M&A transactions, the buyer should review the GGP agreements to identify any consents that the proposed transaction structure would require be obtained prior to the closing.

Thus, in the proposed sale of one or more entities owning the midstream assets, the agreements should be reviewed to identify whether they have change of control provisions requiring consent or notice; and if the proposed transaction structure of the sale of the midstream system is via asset sale, the agreements' assignment provisions should be reviewed to identify whether the producer's consent is required for the assignment of the agreements. As always, careful attention should be given to the particular language used in these provisions.

The buyer will also want to understand what consent requirements the GGP agreements may impose on a potential sale of the producer or its assets, and considerations similar to those in the immediately above paragraph would apply to any such sale.

In addition, the agreements should provide that, if the producer transfers or disposes of any interests in the oil and gas leases which are the subject of the acreage dedication, then any such disposition shall be expressly subject to the GGP agreement and shall state such in the instrument of conveyance.

This article has provided only a general overview of some of the key provisions in GGP agreements which acquirers of natural gas gathering systems and processing plants should review in connection with their legal due diligence review (others not discussed herein, due to space constraints, include force majeure, indemnities and remedies).

Because so much of the value of the gathering system and/or processing plant depends on the associated gas gathering and processing agreements, buyers would be well-advised to devote careful attention to the key provisions of the associated gas gathering and processing agreements, including those set forth above.

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[1] See Mem. Decision on Motions of Nordheim Eagle Ford Gathering LLC et al. at 11, In re Sabine Oil & Gas Corp., No. 15-11835 (Bankr. S.D.N.Y., May 3, 2016).
[2] See In re Sabine Oil & Gas Corp., Case No. 15-11835 (SCC), 2016 WL 890299 (Bankr. S.D.N.Y. Mar. 8, 2016).
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